DOW THEORY LETTERS INC.

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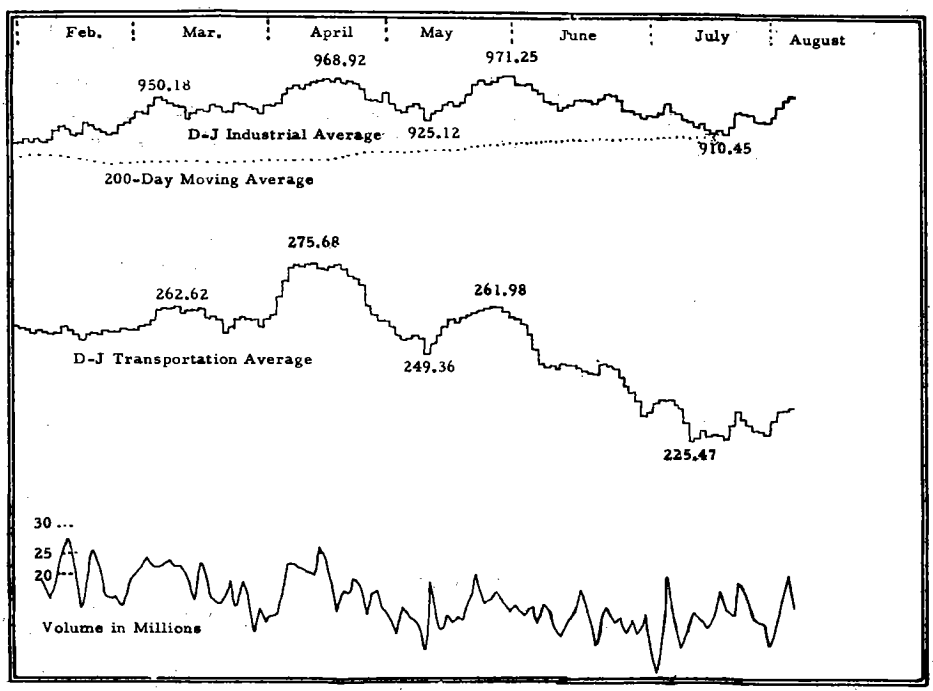
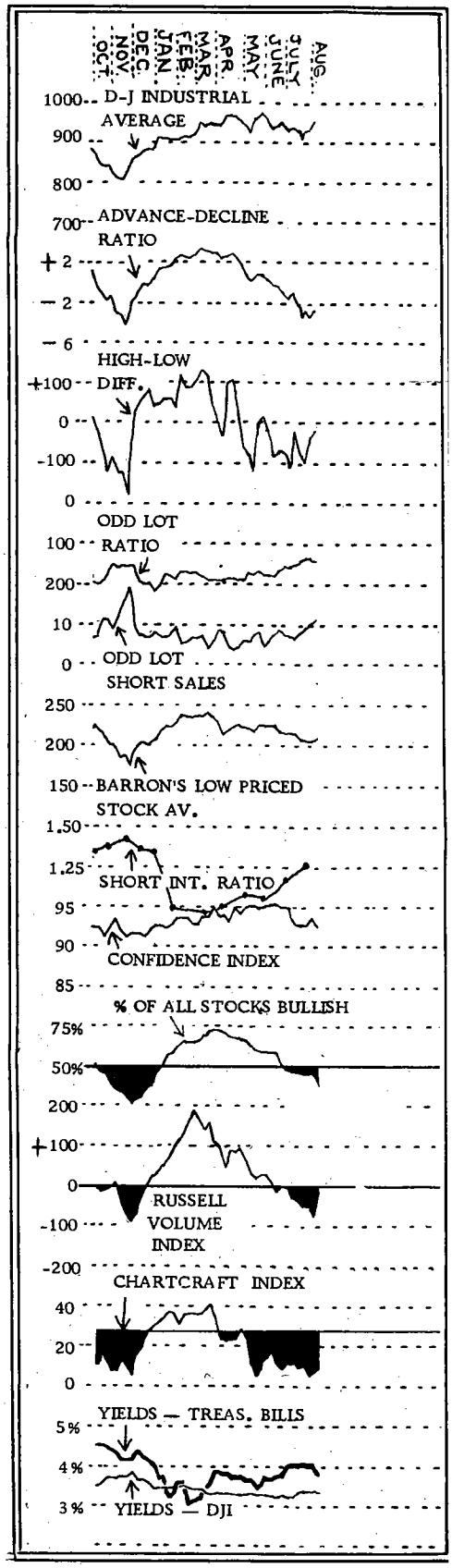
THE MARKET: The really surprising factor in today's market situation is the chorus of analysts (and this most definitely includes the technical analysts) who are telling each other and all those who will listen that "the fundamentals are good and getting better. In fact," they say, "the fundamentals are so good that it will be almost impossible for the market not to be swept up to or above the all-time highs."

All this may be true but I have two basic comments. (1) I believe that this market is about the same market it always was. In other words, it discounts. I believe that the improving business scene has been shouted from the rooftops, it is known by everyone and his brother, and that the market has already discounted it. (2) I do not believe I have ever seen a time when the "technicians" so completely abandoned the technical position which states that the market forecasts the economy rather than the reverse. We are now being told that the market "is bewildered," it does not see what everybody who reads the newspapers sees, and that as soon as the market does see how good business is going to get, it will roar skyward (I suppose with the technical situation improving as the market heads higher).

"What is going on?" I ask myself, and the only answer I can come up with is that the haggard performance of the market so far in 1972 is flying in the face of what people are reading and what the politicians want them to believe. The nation is being subjected to a massive, pre-election propaganda program to the effect that "everything is rosy and getting rosier," and that it is only a matter of time before Wall Street wakes up and starts seeing reality. Maybe so, but it seems to me there is some sloppy thinking going around.

Then again, it is always possible that everyone is looking at the wrong headlines. For instance, (see news clip page 2) it was announced last week that the US trade gap





widened to $590 million in June, up from a horrendous $552 million in May. And a few brave Government officials announced that the US trade gap this year will be more than twice that of last year, a year when we sustained a record $2.05 billion deficit. To put it another way, we are now running a deficit at the annual rate of $6.7 billion, and this after last year's dollar devaluation which was supposed to help our trade situation! To illustrate what is happening, I have included a chart of the US trade situation, showing the annual rate of surplus or deficit as reported quarterly.

The fact is that the trade situation is intolerable, it could not come at a worse time, it exerts an additional downward pressure on an already weak, unwanted and inconvertible dollar, and it will only serve to heighten the already desperate feelings of Europeans towards the dollar. Is it any wonder, in view of the outflow of continuously inflating dollars, that gold is pushing to new record highs?

I am asked about McGovern. I think the market has "discounted" McGovern. As matters now stand and barring some drastic change, I do not believe McGovern has a chance. (Although it is true that he has nowhere to go but "up"). Finally, there is the matter of taxes which will be very much an issue in 1973. Huge pools of new money

U.S. Trade Gap Widened in June, Set Mark in Half

Six-Month Deficit Reached $3.34 Billion With Drain of $590.3 Million During June

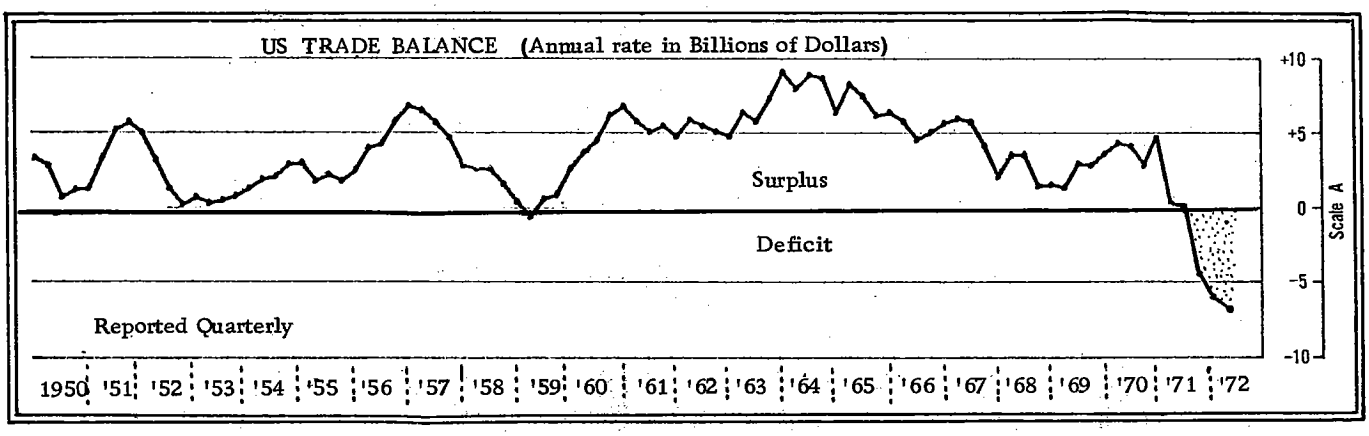
Leading Indicators Up Again

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON—The Nixon administration received fresh evidence that its economic policies, while continuing to fuel domestic business growth, hadn't started to ease problems on the international trade front.

The latest Commerce Department figures for June show:

—The trade deficit widened to a seasonally adjusted $590.3 million from $552.4 million in May; imports exceeded exports by a record $3.34 billion in the first half of the year, up sharply from $2.05 billion in all of 1971.



will be needed during 1972-73, and as soon as the election is over I expect the new President to start talking cold facts to the American people. The market knows this, and it knows that part of those facts is a pressing need for new money, both from the bond market and via taxes.

So much for the less publicized area of the economic and political situation. The market couldn't care less whether "forthcoming events" are publicized or not, it simply deals with them (in the discounting process). And when the Averages refuse to go to new highs in the face of glowing newspaper headlines, take it for granted that (1) the headlines have already been well digested, and (2) the market is looking in another direction.

As far as the Dow Theory is concerned, the market has moved itself into a rather extraordinary position. On July 12, the Transportation Average recorded its decline low of 225.47. Six trading days later, on July 20, the Industrials established their own decline low of 910.45. Two weeks of backing and filling followed, then a sharp rally which produced bullish little upward zig-zags in both Averages.

In less than a week of upside action, the Industrials have put themselves within striking distance of their 1972 high of 971.25 (see page 1 chart). But Transports are far below their own 1972 peak of 275.85. Thus, the Industrial Average, which resisted valiantly on the downside throughout all 1972's technical deterioration, is ready to try for the highs "at a moment's notice." But the other two Averages (Transports, Utilities), and the rest of the technical indicators, have been left far behind. The question: Would a new recovery high on the Dow Industrials be a triumph for the market, or simply a non-confirmed and deceptive "go" signal for the public, a signal which could lead the way to a wide-open collapse in the market? This will be discussed in the next section under "Technical Picture." But from the standpoint of Dow's Theory, it should be remembered that a movement of one Average, unconfirmed by the other, is never valid and is more often than not merely deceptive.

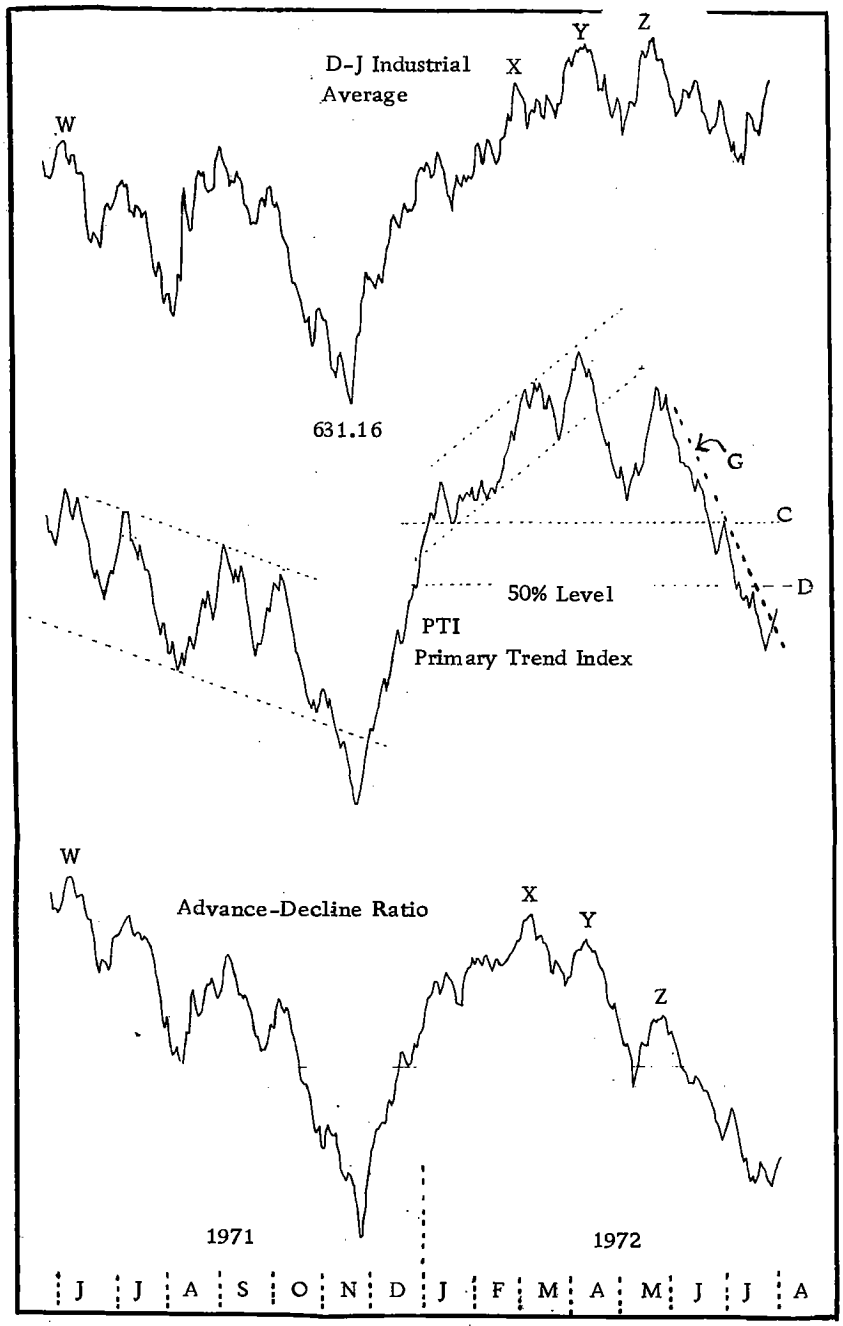
TECHNICAL PICTURE: Throughout early 1972 I took issue with those who promised an immediate wild ride "over 1000" for the Dow. On January 19, 1972 (Letter 518) I reprinted the news clip in which Treasury Secretary Connally stated that " I

think we'll break 1,000 this year without any question, maybe 1,100." At that time I wrote, "Mr. Connally is making an unqualified prediction regarding the Dow, a procedure no ethical analyst in the business would even attempt. So I ask myself, what can you do with an Administration like this one? Are men without principles fated to continue to hold the power? I wonder?"

I didn't have to wonder very long. Mr. Connally resigned a few months later. The Treasury Secretary who predicted that gold would be on its way out and the Dow would be on its way up could not have been more wrong. Yet who knows how many gullible investors he lured into the market near the highs with his unprincipled predictions?

During the course of 1972 I presented study after study to show why I did not think the Dow was headed over 1000. I discussed the technical deterioration in the high-low index, in the Dow short interest ratio, in the groups advancing, in the volume studies, in group high-lows, in the Transportation and Utility Averages, in the bullish percentage of stocks and groups, in the most active stocks, and in countless other areas.

Perhaps the strongest warning was issued in Letter 530 (May 26, 1972) in which I drew attention to the ominous "triple divergence" between the advance-decline ratio and the Dow. "In the past," I wrote, "such 'triple divergences' have been the forerunners of trouble ahead. Thus the Dow-A-D ratio relationship is building up to probable major trouble before the second quarter of 1972 is out." The market mess arrived on schedule, but to my knowledge no other advisory service drew attention to the "general alarm" provided by price (the Dow) and breadth (the A-D ratio) during February to May, 1972.



In Letter 531 I compared the price-breadth relationship of 1972 with that of 1966 and concluded that "...the price-breadth relationship of 1971-72 is as poor as I have ever seen it. The elements of time (13 months without breadth bettering the April, 1971, high) and the 'triple divergence' ... make the whole structure look ominously bearish."

So much for the review of past events. At this time I want to discuss the current implications of the price-breadth relationship, as well as discuss the Primary Trend Indicator (PTI) first introduced in Letter 535.

The accompanying chart shows the daily closing of the Dow Industrials, the daily path of the PTI, and at the bottom of the chart the daily advance-decline ratio. First, note that although the Dow during April, 1972, was well above its 950.82 peak of April, 1971, (the '71 area is marked W on the chart), the A-D ratio at the April, 1972, peak (X on the chart) was well below its earlier 1971 peak (W on the chart). This was a flagrant non-confirmation which alone suggested trouble ahead.

Next, we see the series of three ascending peaks on the Industrial Average (X, Y and Z) with the corresponding series of three descending peaks in the A-D ratio. This constituted the "triple divergence," a rare and very dangerous technical phenomenon which has been the prelude to a number of outstanding previous stock market collapses.

As proof of the power of this triple divergence formation, note that the A-D ratio at the July 31 low had wiped out almost all the gains since the November, 1971, lows. At the November, 1971, low the Dow stood at 797.97. This kind of violent cave-in in the A-D ratio means that the great majority of stocks have eroded badly since the April, 1972, highs. It also means that many stocks have entered the area of their late-1971 lows.

Now I want to turn to the PTI indicator which, if readers remember, is comprised of eight critical market indices including four price averages, a bond average, the A-D ratio, the most-active stocks daily, and the daily high-low figures. The breakdown and early warning signals given by the PTI were discussed in previous Letters.

The main "support" on the PTI is marked by the horizontal trendline C on the chart. This support was broken on June 29, 1972. The halfway level of the entire 1971-72 advance for the PTI is designated by horizontal trendline D. This level was broken on July 13. I believe the 50% or halfway area of every technical movement is significant. When the halfway point of the entire 1971-72 advance for the PTI was penetrated on the downside, I felt that great technical damage had been done.

On August 1 a sharp rally sent the market higher. It now becomes most important to note what the PTI does on the upside. The move down from the May peak was marked by broad and sweeping technical weakness as gauged by the steady drop in the PTI to the July 31 low. I drew a descending trendline from the May peak, a trendline which drops so steeply that the first rally of any substance was bound to reverse this trendline to the upside (the trendline is marked G on the chart).

On August 3 the Dow climbed over 6 points and the trendline G was reversed to the upside. This penetration, while a plus, constitutes simply a first hopeful signal for the bulls. Of more interest to me are the levels of C and D on the PTI. The D level happens to fall on the little late-July peak on the PTI and the C level falls at the early-July peak of the PTI. The Dow has bettered both its July peaks, but the PTI has come nowhere near confirming. Failure to better D and then C on the part of the PTI will suggest that the current rally was just another distributive "blow-off." On the other hand, a rise by the PTI first above D, then above C, will imply that the rally has technical substance, and that the Dow has a good chance of assaulting the high for the year at 971.25.

It is also worth noting that the A-D ratio has pushed up rather sluggishly from its July 31 low but is still far under its early-July peak. Thus, the rally, so far, has been viciously selective and greatly lacking in breadth.

BULLISH PERCENTAGE: The accompanying chart (page 5) has appeared several times in these reports. It is constructed from weekly tabulation released by Chartcraft, Larchmont, NY 10538. I find the chart valuable because (1) it shows where we are on a comparison basis, and (2) it shows when broad market movements are reaching extremes.

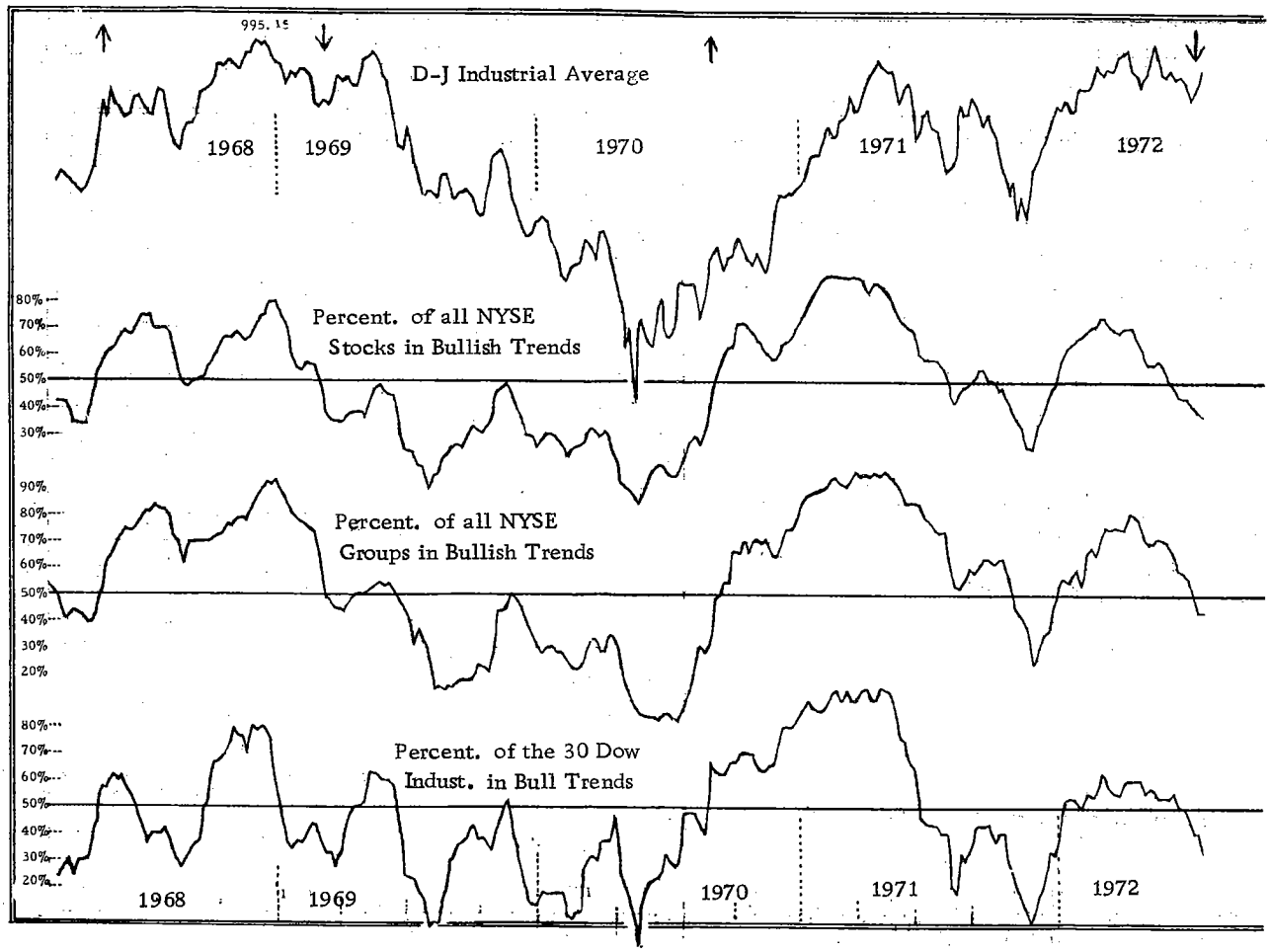
Shown below the D-J Industrial Average are (1) the percentage of all Big Board stocks in bullish trends, (2) the percentage of all NYSE stock groups in bullish trends, and (3) the percentage of the 30 Dow Industrial stocks in bullish trends.

The all-stock and the 30-Dow stock bullish percentage lines tend to be the most sensitive, while the group bullish percentage line tends to lag. In major bull movements, all three lines usually go to or above 80% bullish, while in major bear movements all three lines will usually drop below 20% and in particularly severe bear collapses (such as 1970) the lines may even smash below 10%.

Obviously, these indicators will never tell us how far a move will carry or how long it will last. But they will tell us when the overall picture is bullish or bearish and when the trend has gone to extremes. In general, I would say it is a bearish climate when the all-stock bullish percentage is below the critical 50% level; it is bullish when that line is above the 50% level. It is a good bet that when the all-stock and the group bullish percentage cross above the 50% level, the market will work considerably higher. The converse is true when they both drop below the 50% level.

Because the breadth of the market (A-D ratio) has been so poor in 1972, it was not surprising that the all-stock bullish percentage line was the first to plunge below 50% and thus turn bearish. This occurred on June 19, 1972. On July 12 the Dow Industrial bullish percentage confirmed by sinking below the 50% level. On the week ending July 28, the group bullish percentage confirmed by breaking below the 50% bullish level. Thus, with the July 28 reading, all categories showed less than half of their components in bullish trends.

Actually, since 1968 there have been only four instances where all three of the bullish percentage categories shown on the chart have moved above or below the critical 50% lines. The arrows at the top of the chart indicate the points at which the three indices all turned bullish (above 50%) or bearish (below 50%).



The plunge of the percentage of groups bullish below the 50% level on the week ending July 28, 1972, represents the first time all three indicators have dropped below 50% since the signal which was registered during the first quarter of 1969. What this latest bearish signal means we will find out during the period ahead.

THE MUTUAL FUNDS: Everyone knows that the mutual funds are now suffering net losses of assets stemming from the fact that redemptions are outpacing sales. This phenomenon, relatively new for the mutual fund industry, has been a characteristic of the 1972 market.

Less familiar, however, are the statistics on how these losses are affecting the market. I have included a chart (page 6) showing the balance of mutual fund stock transactions for the period of late-1970 to date. For the year 1970 funds purchased common stocks on balance during every month. During 1971 fund net losses began to appear, and as a result funds sold common stocks on 7 out of the 12 months of that year.

This year as fund losses (due to redemptions over sales) continued, funds found the situation particularly difficult. This is because they are not only losing money on balance but the funds' cash position is very low. As a matter of fact, the May figures showed mutual funds in a cash position of 4.6%, one of the lowest figures in history (the lowest figure was the 4.3% of December, 1961, just before the 1962 collapse). In June the cash position rose slightly to 5.2%, a result of liquidation of common stock and by the drop in the stock market (lowering the assets of the funds as well as the cash ratio's denominator).

It is of particular interest that so far in 1972, the funds have sold stock in four of the first six months. Furthermore, the $423 million in common stock sales during June of this year was surpassed only by the $425 million sales figure which occurred in April, 1972.

No one knows exactly what all this means, and so far much of the effect of the fund selling has been hidden by the buying of pension funds. Here too, the picture is not entirely a happy one since pension funds have gone way overboard in their percentage of stock purchases. Many pension funds have invested 100% of new cash during the past year in a frantic effort to boost their common stock position. Such procedure must shortly end, however, with pension funds cutting back sharply on common stock purchases.

With mutual funds losing cash due to redemptions during the past five months running, I would expect the mutuals to exert steady pressure on the stock market, as suggested by the chart. Thus, the big mutual fund "plus" which was touted to the sky only a few years back is becoming a minus, along with the exit of the "little fellow," as exemplified by the odd lot statistics.

GOLD & SILVER: After hitting an all-time high price of $70 per ounce last week, the price of gold corrected towards the mid-$60's as shown on the chart. A price of $70 obviously has significance since this is exactly double the old $35 price which the US insisted gold "should be" worth. At the new above-$60 price, many mines can be expected to re-open, other new mines may start up, and low-grade reserves which were not profitable to mine at the old price may now come to light (see note Assoc. Press story).

Meanwhile, silver at around $1.82 is up almost 50% from last year's low as it pushes high, propelled by the same forces which push gold higher. One of the best students of mass psychology is E. George Schaefer, the Dow Theorists from the mid-West (910 E. 38 St., Indianapolis, Ind. 46205). In a report last week Schaefer writes, "As I see it, we are going to witness 'the greatest spectacle in the history of the stock market' as the crowd of inexperienced investors and speculators of today learn what the gold and silver picture is all about during a 'period of inflation' and 'currency devaluations' that the stories from Europe continue to tell us every day. All the serious investor can do is to inform himself, and then do something to save himself."

Does the above quote from Schaefer sound "far out"? Perhaps, but then in 1949 Schaefer was the only man I know who was talking about a great bull market which would ultimately go far above the 1929 highs of 381 on the Dow (a thought which seemed impossible in 1949).

South Africa's Older Mines May Reopen

JOHANNESBURG (AP) — South African mining finance houses have begun a systematic search through records and surveying plans of areas containing gold ores that were previously unprofitable but would now be profitable with a free gold price above $60 an ounce.

Mining houses are saying nothing, but informed sources say they are considering the possibility of opening new mines or extending existing mines into ground that was drilled many years ago.

Anglo American Corp. is reported to be re-drilling ground it owns to the south of the profitable President Brand and President Steyn gold mines in the Orange Free State.